

## Governing partnerships

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## GOVERNING PARTNERSHIPS

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### Abstract

*Public private partnerships (PPPs) are instruments of the public interest, yet bodies that actively engage private actors. As a result, questions of governance are particularly important. Here, governance refers to the rules that prescribe who should make, execute and be accountable for the conduct of a PPP, and in what way that conduct should be exercised, for example through consultation with interested parties, transparency in decision-making, and so on. This chapter explores four facets of PPP governance: legal, regulatory, democratic, and corporate governance. Legal governance has implications for the allocation of roles and responsibilities between the parties to the PPP, the PPP entity itself, and the state and citizens more widely. Regulatory governance covers the legal and contractual obligations on parties, the procedures through which they are enforced, and the softer norms that operate around these. Democratic governance concerns the empirical and normative question of what is, and what should be, the level and form of constitutional oversight of PPPs. Corporate governance concerns itself with ensuring that the enterprise is managed in a manner that does not put the future of the business and investors funds at undue risk. The chapter concludes that the key task in developing the governance of PPPs is less to do with their financial probity, and more with aligning their mode of operating to the fundamental democratic values of the wider public service.*

### The significance of PPP governance

PPPs are a sub-set of the tools of government – institutional arrangements through which public policy is mediated. Their status as instruments of the public interest, yet bodies that actively engage private actors, means that questions of governance are particularly important. The design of appropriate governance mechanisms provides a way in which that public interest can be protected despite the delegation of authority to business concerns. It creates constraints on the agency of private actors, reducing possibilities for self-interested behaviour at the state's expense. And in contradistinction to the first point, governance structures act as a constraint to the state, enabling private actors to realise the innovative potential that PPPs are intended to promote by virtue of not being part of the state's bureaucracy. In other words, they promote opportunities for self-governance of public activity by private actors at arm's length to the state (Baker, Justice and Skelcher 2009).

The tension between these two purposes of PPP governance is evident in the policy and practice of PPPs, although the weight given to one or the other is influenced by the ideological stance of the observer. Those seeing PPPs from a statist position will emphasise the need to ensure that governance protects the public interest, and thus favour rather more in the way of rules and safeguards than observers who regard PPPs as a way through which risk can be transferred, innovation released and public benefit enhanced. Every PPP failure brings a call for reform in the regulatory framework; but whether this should be enhanced or reduced regulation is a matter of ideological predisposition.

It is also important to contextualise the debate about PPPs and their governance. Some countries, such as the UK, have developed considerable experience with the use of PPPs, a development facilitated by some three decades of neo-liberal political consensus and a well-established set of norms regarding property rights and legal compliance. Asian countries have social and cultural norms that differ from those in Europe and the US, and PPP governance therefore is somewhat different (Common 2000). And within Europe itself, there are significant differences in national contexts that need to be taken into account. For example, Hofmeister and Borchert (2004) argue that Switzerland's culture of consensual decision-making and incremental change, combined with recent significant business failures in that nation, have increased scepticism towards public management reforms based on business models.

Governance, then, is inimical to the debate about PPPs. Governance is a widely used and seldom defined term. In the context of this chapter it refers to the rules that prescribe who should make, execute and be accountable for the conduct of a PPP, and in what way that conduct should be exercised, for example through consultation with interested parties, transparency in decision-making, and so on. These rules may be defined *a priori* by government, an international regulatory agency, or some other legitimate actor. They can also emerge more informally as the day-to-day practices of actors involved with the PPP become institutionalised. The result is a situation where publicly legitimated rules sit alongside those that are determined privately (Mathur and Skelcher 2005). This chapter explores four facets of PPP governance: legal, regulatory, democratic and corporate governance. The emphasis is on publicly legitimated forms of governance; the implication of emergent private rulemaking requires a fuller treatment than is possible here (see, for example, Weimar 2006). The chapter concludes with a discussion of the future governance of PPPs.

## **Legal governance**

PPPs can take a number of legal forms. Each has implications for the allocation of roles and responsibilities between the parties to the PPP, the PPP entity itself, and the state and citizens more widely. The exact form of legal governance will depend on the legislative framework and constitutional norms of individual nations and their relevant jurisdictions. However a number of overall types can be identified (table 1).

---- table 1 about here ----

Public corporations are a longstanding instrument for state enterprises, regulatory bodies, and arm's-length service delivery (Wettenhall 1998). In a PPP context, public

corporations can provide a legal structure that retains a strong connection to the state and thus in theory, but not inevitably, to public interest concerns.

Companies offer the same benefits as public corporations in terms of enabling the PPP to be composed of a single, independently constituted legal entity for a PPP. But unlike public corporations, which have a statutory origin, companies operate under a regime of commercial law. Their establishment thus depends on registration with the relevant regulators. Some companies are limited by shares. For example, some of the PPPs undertaking the improvement of the London Underground are companies whose shares are owned either by a consortium of construction firms or to investors accessed through the market. In this way, the PPP can attract outside investment by selling equity stakes in the company. The benefits of this arrangement have to be considered alongside the disadvantage, which is that the ownership of the PPP can change over time and its value can vary in light of stock market conditions. An alternative arrangement is for the company to be limited by guarantee (the term used may vary depending on the company law of different nations), in which case the members of the company agree to pay a nominal amount to any debtors should the company cease trading. This approach maintains ownership in the hands of members, but restricts the company's ability to access external financing by selling equity.

Rather than constituting a separate corporate entity, contracts are widely used as a form of legal governance for PPPs. The contract sets out the obligations of the two or more parties involved in the PPP, including what is to be delivered or achieved, the payment schedule, discretion on the agent, and the principal's rights of oversight. Private Finance Initiative (PFI) PPPs frequently utilise contracts as the form of legal governance. Other than very simple contracts, specification can never be complete and this opens the way for opportunism by the agent and the possibility of legal disputes regarding the exact meaning of terms.

A form of PPP often used for community-based partnerships is the memorandum of understanding (MoU) or unincorporated association. This is a non-corporate entity created on the basis of an agreement between the individual member bodies, and setting out the purpose of the partnership and how it will be governed. MoU PPPs do not have a separate legal identity and thus cannot enter into contracts, employ staff, or own or control assets. These functions, if necessary, are normally undertaken by one of the member organisations (often a statutory body) on behalf of the partnership. This form of legal governance offers the most flexibility and least constraints on its members. It can be created, adapted and closed as the members' desire. The agency role performed by the organisation nominated to manage contracts and assets means that the PPP can effectively spend resources and undertake activities with a financial dimension, but without the formality or constraints of a company or public corporation. The disadvantage is that the voluntary agreement that created the PPP may not be sustainable over time, and thus this arrangement is not suitable for typical large PPP infrastructure projects.

Some countries have common ownership forms of legal governance, for example co-operatives and mutual societies, in other words non-state public interest companies. The advantage of this form is that it relaxes some of the legal requirements that apply to normal profit-seeking companies, because it is recognised that a public interest company is working for the wider public benefit not a narrow private interest. This

can help to overcome some of the constraints on directors in companies, who typically are required by company legislation to put the interests of the company first. This can cause problems where the directors are representatives of participating organisations, and thus may not be able adequately to reflect their interests.

Corrigan, Steele and Parston (2001) argue that the use of such public interest forms of legal governance would enable greater opportunity to innovate, and yet remain accountable to and work in the interest of the wider community. This is a model that might have advantages for partnerships which wish to incorporate so that they are able to employ staff, enter into contracts and act on their own behalf, yet where accountability to the community is particularly important and the idea of a company limited by guarantee does not seem appropriate.

The decision on the legal form to utilise will be influenced by two factors. The first factor is the type of PPP, discussed by Hodge, Greve and Boardman (2010). Each type of PPP is better suited to one of the forms of legal governance discussed above. Thus, long term infrastructure contracts would normally be best suited to a company form of legal governance, while in institutional co-operation for joint production a public corporation model could provide the necessary framework. Although there are no hard and fast rules about which legal form fits best which type of PPP, there are clearly some general indications (table 2).

---- table 2 about here ----

Second, the choice of legal form reflects the extent to which the constituent parties agree to integrate their activities into a separate entity. PPPs can be loose associations in which partners maximise their autonomy consistent with undertaking some collective activity, or agree to combine their resources into a new entity of which they are members but not necessarily in a controlling position. This is the classic joint venture, a new body established by a set of organisations on the basis that its independence would generate benefits for them. Over time, partners' attitudes to integration or autonomy will change. And so the temporal aspects of partnership formation and incorporation are important to understand. It may take a period of operation as a MoU PPP before the partners will be willing to move to greater integration as a company.

### **Regulatory governance**

Regulatory governance concerns the system of rules that connect the PPP to the public client. It covers the legal and contractual obligations on parties, the procedures through which they are enforced, and the softer norms that operate around these. It is what Koch and Buser (2006: 551) term 'metagovernance': 'various types of soft law, incentives, guidelines, brokering activities and legal mechanisms'. Because government is the guarantor of last resort for a project, market incentives on the PPP and its commercial partners are reduced. Thus there is a corresponding need for effective regulatory oversight to assure the public's policy and fiscal interests are served. Problems of governmental capacity are even more pronounced in developing and transitional states. A case study of China's urban water sector shows that the fragmentation and diversity of the regulatory systems inhibits the effective

involvement of foreign direct investment in PPPs to improve water management (Zhong, Mol and Fu 2008).

At the most fundamental level, the public client will be subject to legal requirements concerning the process to be followed and criteria to be applied in the procurement of private actors to participate in a PPP. The scope, detail and complexity of these legal rules will vary from country to country. In the European Union, for example, there is a set of procurement regulations that apply to all member states (Maslyukivska and Sohail 2007). This compares with, for example, China, where the public law framework is more limited due to the tradition of state ownership of production and absence until recently of significant private actors in a market context. Here, the legal framework was inadequate to enable effective separation of public and private assets, and only recently has legislation to protect private assets been introduced into the legal code (Adams, Young and Zhihong 2006).

The rationale for such overarching legal frameworks is to provide transparency for the process of determining the selection of the private actor to participate in a PPP, and the way in which public and private resources will be applied to the PPP. This creates, at least in theory, a level playing field for potential investors, as well as prescribing mechanisms for the resolution of any disputes and agreement of contract variations. Given the scale of infrastructure PPPs, such frameworks should reduce the risk of corruption and opportunism. They should also ensure that the public interest is protected, for example by requiring security bonds to be issued against financial default or non-performance by the private actor (Deng, Tian, Ding and Boase 2003). However Bloomfield (2006) points out that in the US case, if not elsewhere, the unique structure of PPPs combined with an environment in which deregulation is the norm leads to a situation in which there may be special waivers of standard procurement procedures.

There has been a considerable discussion in the literature about the value or otherwise of legal as opposed to quasi-legal and relational contracting (Sullivan and Skelcher 2002). PPPs require some form of legal contract because they involve public resources. However the question is whether the interaction between the parties should be regulated as a matter of legal obligations, and thus tested through the courts, or by way of quasi-legal arbitration mechanisms or through softer forms of regulation. The solutions to these problems are inevitably contingent. Societal norms and the underlying attitudes towards the way in which business should be conducted will be important determinants. The impartiality of the courts may or may not be assured. And the imperatives for project delivery may also be important considerations, with speed of delivery leading to a more pragmatic approach to contract relations on the part of public actors.

Arbitration mechanisms provide a reasonable middle way between legalistic and informal modes of regulatory governance, provided the social infrastructure can offer a reasonable guarantee of impartiality. They offer the parties an opportunity to put their cases before a knowledgeable but independent arbitrator or arbitration panel, who may be able to identify and broker solutions not previously considered by the parties. In Europe and some other parts of the world it is now common practice for construction contracts to include provision for arbitration prior to any legal dispute

resolution. Professional associations may offer their own arbitration service, enabling a process of peer judgement to be applied.

Relational contracting occurs where the parties engage in dialogue about issues arising from the interpretation of contracts, unforeseen events, changes in operating conditions, or external contingencies that affect implementation of the PPP. This is often mistakenly presented as a softer form of regulatory governance, but can be quite hard edged. Private actors can deploy negotiating and commercial relationships skills for which public actors are unprepared, including the practice of offloading less profitable parts of the operation to third parties over whom there is less control and attempting to renegotiate aspects of the contract as it is being implemented.

The unfortunate conflation of relational contracting with the idea of ‘trust’ adds to the problems public actors can face, since it creates the impression that all that is required are good inter-personal relations. Rather, trust should be considered as a measure of predictability of behaviour. The behaviour could be virtuous or wicked from a public interest perspective, and thus trust is a normatively neutral concept rather than one associated with positive virtues. Predictability would be a better concept to use, in the sense that it avoids the normative baggage of ‘trust’. Thus, a public client might well predict on the basis of past experience that a given private actor would behave opportunistically. In this sense, a healthy dose of *mistrust* would be beneficial for the public interest!

Governments can assist public actors to minimise problems of regulatory governance, and avoid legal dispute resolution, by generating and transferring knowledge from PPP experience. Research on the German case shows that PPP Task Forces and Knowledge Centres can improve procurement processes and enhance value for money (Fischer, Jungbecker and Alfen 2006). In the Netherlands, the PPP Competence Centre provides a similar role, and there are equivalent bodies in a number of other countries. Bodies such as Partnerships Victoria, a division of the Victorian State Government in Australia, take this approach one step further by providing a single gateway for potential PPP projects, bringing together both expertise in developing and managing PPPs with public interest considerations.

### **Democratic governance**

PPPs raise important issues of democratic governance due to the changed nature of the state when it transfers public responsibilities in whole or in part to third parties, or engages in cooperative activities with third parties. Ranson and Stewart argue that: ‘Organisations in the public domain are required to account for their actions in the public arena of discourse and there has to be a means by which they are held to account by the public on whose behalf they act.’ (1994: 94) But forms of third party government like PPPs muddy the waters of accountability. They introduce the problem of the ‘democratic deficit’, which refers to the shortfall in the accountability arrangements of a non-elected public body with reference to those applying in the elected sector. This is not just a matter of whether electoral arrangements do or do not exist, but also to the other systems that support democratic accountability including access to information and codes regulating standards of conduct (Sands 2006).

PPPs embody two potentially competing institutional logics – the logic of democratic accountability in a public arena and the logic of commercial competitiveness in a private setting. Thus, for democrats PPPs are too private and lack the transparency normally associated with governmental activity. That transparency covers input, throughput, and output stages in the policy process. In contrast, the prevailing logic in business is to see accountability at the output/outcome stage – in terms of sales to customers and profit to owners. This is the pre-Corporate Social Responsibility (CSR) market logic, in which why and how a good or service is designed and produced is immaterial to the customer; what matters is whether it does what the customer expects, or can be persuaded to expect. CSR is changing the orientation of business to give greater attention to input and throughout considerations (for example, the sourcing of products from renewal stock and the ethics of employment conditions in a global market). But CSR remains a matter of debate in the face of a deeply embedded institutional logic of competitiveness in which global production obviates a level ethical playing field for the foreseeable future.

This raises the empirical and normative question of what is, and what should be, the level and form of constitutional oversight of PPPs? (Bovaird 2004; Skelcher 2005) Currently, oversight other than of outputs is limited. There are plenty of reports by government audit agencies on the results of using PPP mechanisms, and some interim analysis, for example of the application of the public sector comparator in particular cases (e.g. from the UK's National Audit Office). These are sometimes considered by relevant committees of state and national legislatures, or by ministers. But public oversight and debate about individual PPPs as they develop is much more limited.

This is not just a matter of commercial confidentiality. Pro-PPP governments benefit from this opacity given the sometimes very marginal decisions made in public sector comparator analysis, and the opportunities to massage the assumptions fed into the process (National Audit Office 2001). More fundamentally, the problem of classification comes into play. PPPs are a form of quasi-governmental body, yet like other quangos they emerge through pragmatic and *ad hoc* processes and in a multiplicity of forms (Guttman 2003). They are frequently a function of executive rather than legislative decision and thus comprise a judgment about technically appropriate means rather than public policy ends. The creation of effective constitutional oversight requires as a first step the clear demarcation of this class of organizations.

### **Corporate governance**

Corporate governance concerns 'the procedures associated with the decision-making, performance and control of organisations, with providing structures to give overall direction to the organisation and to satisfy reasonable expectations of accountability to those outside it (Hodges, Wright and Keasey 1996: 7). Its focus is on the organisation's board, the roles of chief executive, the chair of the board, directors and senior management, in the context of structures and systems for strategy, financial and risk management. Essentially, corporate governance concerns itself with ensuring that the enterprise is managed in a manner that does not put the future of the business and investors funds at undue risk.



We know very little about the corporate governance of PPPs. This is an issue where few researchers have ventured. In part this may be due to problems of access into an arena where commercial and political sensitivities are pronounced. But it may also be that the academic debate has concentrated on the theoretical, financial and substantive pros and cons of PPPs at the expense of empirical examination of their internal workings. Some literature is now beginning to appear. Johnston and Gudergan (2007) use the case of Sydney's Cross City Tunnel to show how the different incentives operating on public and private partners threatened the viability of the PPP Company and ultimately caused its collapse. Rubin and Stankiewicz (2001) provide a detailed analysis of the Los Angeles Community Development Bank, an innovative PPP for economic revitalization. However, we still lack a sufficient number of detailed studies of the day-to-day corporate governance of PPPs.

The two studies cited above both reveal that the structural tensions built into a PPP, by virtue of operating both in public and business environments, have a significant impact on the viability of the two examples. This suggests that there is a particular challenge for the development of systems of corporate governance for PPPs. The PPP cannot be regarded as a unitary organisation with a singular institutional logic. Rather, it is a multi-organisation encompassing several institutional logics. It is also an open system, where the external environment can have a significant and immediate impact – for example, a change in government policy. The approach to corporate governance may therefore need to be more flexible and adaptive than is conventionally the case, mediated through broker or boundary-spanning roles that facilitate early warning of changes in the environment and the opportunity for dialogue and negotiation at an early stage (Baker 2008).

### **PPP governance: key imperatives and conditions**

The legal, regulatory, democratic and corporate governance of PPPs are all concerned with managing the risks inherent in third party government (Salamon 1981). These risks are well understood at a theoretical level in the institutional economics framework, with its concern for the analysis of principal-agent relations under different governance regimes. However scholars need to explore other areas of theory that have the potential to offer new insights into the governance of PPPs. For example, political science has a conceptual language to describe the accountability, transparency and public interest issues involved with PPPs, but the theoretical formulations relevant to third party governance are less well developed. Equally, methods of analysis are still relatively simplistic due to the domination of approaches oriented to elected bodies (Mathur and Skelcher 2007). Thus the prescriptions generated by this discipline not so well advanced. Newer areas of theory, for example complexity science, can make a contribution to understanding the structure and evolution of PPPs under different and changing environmental conditions, for example through the use of concepts such as 'fitness landscape' (Klijn 2008). In essence, my argument is that scholars need to expand from the tried and tested areas of theory and search out literatures that can generate new understandings of PPPs and in the process inform public debate, policy and practice.

The significance of national contextual factors, discussed earlier in this chapter, mean that generic prescriptions for PPP governance need to be expressed at a relatively

broad level. Smith, Mathur and Skelcher (2006) offer a set of such generic prescriptions based on their study of partnerships in the UK, which are adapted here:

1. *Deliberative governance design*: The process of governance design should be deliberative, engaging those groups and agencies relevant to the partnership's policy goals in exploring and determining the governance form.
2. *Proportionality*: The governance systems should be proportional to the responsibilities and risks of the partnership. Some PPP spend considerable amounts of money and have a major impact on the community; others have few resources and are essentially about facilitating cooperative effort.
3. *Balancing performance with conformance*: PPPs are created to deliver projects. This performance imperative needs to be balanced against conformance with regulatory conditions.
4. *Facilitating new legal forms*: The limitations of public company forms are well known. The debate on "public interest companies" and co-operative legal entities offers an important way forward.
5. *Mechanisms for public accountability*: There should be a regular and stable process whereby the intentions, decisions and actions of a PPP can be exposed to the scrutiny of the public. Accountability should not rest purely on the output side of the policy process.

This discussion of the various aspects of PPP governance brings us back to the constituting conditions for public action. These require government that works in the wider public interest, follows proper standards of conduct, is transparent in its decision-making, and is accountable to citizens. It is clear to see how this might operate in an elected body or executive agency, but it becomes more complex for a PPP because of the different legal forms that it could take, the tendency to weaker standards of corporate governance, and the principal-agent problems in effective regulation. And underlying these differences is the fundamental tension with which we started the chapter – that between tighter governance to protect the public interest on the one hand, and on the other the case for weaker governance to enable risk-taking and innovation, and incentivised private actor participation in the provision of public services and infrastructure.

In conclusion, the key task in developing the governance of PPPs is less to do with their financial probity, and more with aligning their mode of operating to the fundamental democratic values of the wider public service. The flexibility in legal and corporate governance available to PPPs offers the opportunity for interesting and creative ways of addressing this imperative. Thus far, the governance of PPPs has predominantly been used to remove them from public scrutiny and informed debate, justified on the grounds of commercial confidentiality or managerial discretion. But, as I argued at the start of this chapter, PPPs are inherently instruments of public action. The challenge for normative theory and institutional design is to ensure that the public purpose of PPPs is properly expressed in the form of governance and its constitutive rules, and is subjugated neither to an ideology of commercialization nor an alternative form of governance arising from the formalized practices of the private actors involved in managing a PPP.

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**Table 1: Structures for legal governance of PPPs**

<b>Legal form</b>	<b>Description</b>	<b>Primary accountability</b>
Public corporation	Statutory body created through legislation and with defined duties and powers. This creates a public entity that incorporates the various parties in a PPP. May be employed in place of incorporation as a company.	To government
Company limited by shares	A body incorporated as a company limited by shares. Members of the company will be the parties in the partnership. Shares may be owned by the parties, or may be traded in the open market, thus diluting control. However government may hold a 51% stake or a 'golden share' in order to retain the final say in the public interest.	To the members, shareholders, and others as required by the legislation governing companies.
Company limited by guarantee	As above, except there are no shareholders. Members of the company agree to pay a nominal amount against any debts of the company in event that it ceases trading.	To the members, and others as required by the legislation governing companies.
Memorandum of understanding/unincorporated association	A non-corporate entity, in which the partners agree to work together for the objectives, and in the ways, set out in a non-legally binding memorandum of understanding. Because it is not a corporate entity, the PPP cannot enter into contracts or hold funds. These functions are normally undertaken on behalf of the PPP by one of the partners' organisations.	To the members.

Source: Adapted from Sullivan and Skelcher 2002

**Table 2: Indicative relationships between legal forms and PPP types**

<b>PPP type</b>	<b>Indicative legal form</b>	<b>Rationale</b>
Institutional cooperation for joint production and risk sharing	Public corporation	Maintains state involvement in management of production and risk
Long term infrastructure contracts	Company or contract	Enables partners to manage finances and contracts. Company enables opportunities to seek additional financing through sale of equity stakes
Public policy networks	Memorandum of understanding	Offers flexibility for looser network arrangements
Civil society and community development	Memorandum of understanding or public interest company	Offers flexibility for variety of civil society organisations; or legal structure in which public interest is basis of governance rules
Urban renewal and downtown economic development	Company	Enables partners to undertake range of activities associated with renewal, including infrastructure works, marketing, start-up financing